

Audit's® NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

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INVESTMENT SELECTION & REVIEW: PICKING BUYOUT/LIQUIDATION CANDIDATES

The buyout/liquidation hunt is on -- and you can definitely take part.

Two events bring the topic into the open. One was decision by First Fidelity Investment Trust to sell its properties and liquidate (see RTR, March 10).

Next trustees of Nationwide Real Estate Investors ordered the trust to stop making new loan commitments and either merge, liquidate or hold only long-term loans.

Nationwide shares promptly jumped -- from about 7½-7-¾ bid before announcement to 11-¾. That's up 52% but still an attractive 50% below the \$24.11/sh. book value.

Why is Nationwide giving up the race? It has paid a nominal dividend, of 4¢/sh. recently, throughout the recession, missing only one quarter.

Better, banks recently gave the green light to resume making new investments.

And with nonearning loans stabilizing, trust seemed on a recovery track.

So the pressures on Nationwide tell something for investors.

What triggered the decision is simply that the high cost of funds for a mortgage lending trust caught up with it.

Best example came two hours before trustees made their decision: a \$1.3 million mortgage loan was offered with 1% front-end fee, interest at 2% over the prime rate, and institutional takeout at end of one year. In other words, a prime loan.

Trust managers figured NRELS would earn \$1,300 on the loan after paying for the bank loan -- or 0.1% net spread. That's 1¼¢/sh. for the year -- for 100% of the risk.

This means that banks and savings & loan associations, traditional suppliers of

Comprehensive two-page REIT EVALUATIONS will be ready shortly on these 10 trusts:

<i>First of Denver Mtg.</i>	<i>Institutional Investors Tr.</i>	<i>Tri-South Mortgage</i>
<i>First Pennsylvania</i>	<i>IDS Realty</i>	<i>Wachovia Realty</i>
<i>First Wisconsin</i>	<i>LMI Investors</i>	<i>Prices (prepaid):</i>
<i>Hanover Square Rlty.</i>	<i>North American Mtg.</i>	<i>\$15 each, \$20 the group</i>

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construction money, have so much liquidity they've driven loan rates way down.

Both have lower cost of funds -- hence can lend at rates well below mortgage trusts. Trusts must borrow and then re-lend at a markup or spread.

As middlemen they make out best when construction money is tight -- as in the early 1970s. But when other lenders are flush, their margins are pinched.

Nationwide, for instance, borrows at $\frac{1}{4}\%$ over the prime rate plus compensating balances. Because it's small -- only \$42 million invested assets -- its administrative costs run at a 2.12% annual rate.

All this adds up to wafer-thin return for 100% of the risk on new loans.

What happens next? Nationwide will scout around for merger proposals from other trusts or real estate entities.

Discount dollars are the big attraction. An acquirer theoretically could take over NRELS at somewhere over today's prices but below book value, liquidate, and have surplus equity.

So far, no deals have been announced.

Should you buy NRELS shares at the current elevated price?

We doubt it. Reason: Since the discount is the big attraction, every uptick reduces attractiveness of the shares to a merger partner.

Better we think to focus on shares of smaller entities with big discounts from book value and reasonably solid fundamentals -- the common threads running through both the Nationwide and First Fidelity decisions.

All are under pressure because administrative costs go up percentage-wise as their asset base shrinks.

Candidates? Here are some with same fundamentals from last REALTY TRUST REVIEW:

Baird & Warner Mtg. ($7\frac{1}{2}$ bid OTC) is up recently but still 55% below \$16.14 book value. Small \$45 million asset base spells 1.14% fee and administrative costs, after fee limits. Trust is paying 14¢/sh. annually from last year's income but progress slow.

Central Mtg. & Rlty. ($4\frac{5}{8}$ bid OTC) is also up but a lush 61% below \$11.99/sh. book value. Operating expenses are at a 1.53% annual rate on \$27 million assets.

Security Mtg. Inv. (3 ASE) shares sell 52% below the \$5.98/sh. tangible book value and while portfolio is larger at \$134 million, fee and other administrative costs are a steep 1.95% of average assets. Bank agreement bans dividends through March 1979.

Mortgage Trust of America ($6\frac{3}{4}$ NYSE) has to be put in this category too. Asset base is shrinking, to \$109 million, and fee and other administrative costs were 1.41% of average assets. Trust says it's talking with lenders about making funds available for new loans but shares at 44% below \$12.29 book value might be mergable.

Hospital Mtg. Group shares, a recent recovery recommendation because of good dividend yield and deep discount, have run up to a new high lately but at $11\frac{1}{2}$ (ASE) remain 50% below the \$22.72/sh. book value. Asset base is small \$38 million and so fee and other costs are running at 1.74% rate of average assets.

Other likely candidates would be Western Mtg. Inv., Flatley Realty, Indiana Mtg. & Rlty., and possibly Henry S. Miller Realty.

To this list we'd add two major institutional trusts, not because they're small but because discount from book value is large.

They are PNB Mtg. & Realty and Northwestern Mutual Life Mtg. (reviewed this issue).

But other REIT shares are attractive, too, for different reasons. We review this issue some recent actives, including B.F. Saul REIT and Equitable Life Mtg.

These reviews begin on Page 5.

TENDERS/EXCHANGES: TRI-SOUTH MORTGAGE'S NEW BONDS COULD BE A RARE PIECE OF PAPER

Tri-South Mortgage Investors is offering to exchange a new 10% senior convertible note due 1988 for its two existing defaulted bond issues, as follows:

--\$650 principal of the 10s for \$1,000 par of its 7-3/4% senior subordinated debentures due Feb. 15, 1980; and

--\$500 principal for \$1,000 par of its 7% senior subordinated convertible debentures due 1992.

The new 10% notes would rank equally with unsecured bank debt, meaning that the trust couldn't withhold interest payments if it was paying the banks.

This feature would lift the notes out of the "subordinated" class.

Banks are willing to go along with this simply because the trust is agreeing to repay all bank debt in full by Dec. 31, 1979 -- or 45 days before the old 7-3/4s mature.

TSI has cut bank debt from a peak \$158 million to \$53.7 million at Dec. 31.

Pending swaps are tied to successful acceptance of the exchange and would cut bank debt still further, to \$25.8 million.

And if the exchange succeeds, TSI could wind up with \$8-\$9 million shareholders' equity, bringing the sky-high debt-equity ratio down to earth.

But 10% notes would also be convertible at \$2.50/sh.

Since most convertibles are also subordinated, this makes the proposed senior notes a rara avis for investors.

With TSI shares trading at 1-3/4 (NYSE), the \$29.50 conversion price on the old 7s is unrealistic.

The new price is appetizing compared both to latest book value of \$2.11/sh. and pro forma \$3.94 to \$4.30/sh. if 55% and 75% of holders accept the new paper.

What you do now depends upon your cost basis and how long you want to hold.

The old 7-3/4s have traded up to 73 on heavy volume since the exchange offer began, or a 12% premium.

But this likely doesn't mean that investors see the deal as so attractive they're willing to pay a premium. Why? Because old 7s stay right at turn-in value of 50.

This means to us that many sophisticated investors see possibility of strong price rise for the 7-3/4s that don't tender and want to buy into that prospect.

They recall that untendered Barnett Mortgage 8 1/2s jumped from 40 to 60 when exchange offer succeeded.

So buying in now on the 7-3/4s to hold to maturity depends on how high their price could go -- assuming tender is successful.

They mature in less than two years, Feb. 15, 1980, so potential yield to maturity is about 21%. Providing back interest is caught up and future interest paid.

Chances appear good that could happen: TSI held \$12 million cash and equivalents on Dec. 31, more than enough to cover \$7.3 million accrued unpaid interest.

Offering circular says interest on old debentures you might keep won't be paid unless all senior debt defaults are cured. But it also discusses a record date for this back interest. We think it will be paid sometime.

We'd guess there is more upside potential in the 7-3/4s--if exchange succeeds.

If you hold either old debenture at or near par, we'd suggest tendering at least the 55% minimum needed to make the offer succeed.

That's because a failed tender could force the trust into a no-win bankruptcy.

A successful tender essentially gives TSI a shot at paying off both banks and the 7-3/4% debenture holders on schedule. Without the exchange, debenture holders will be squeezed by the maturity crunch at end of 1979 and early 1980.

And if tender succeeds, portfolio appears to have enough liquidity to meet all

debt maturities. Our new REIT EVALUATION of Tri-South (see page 1) gives more details.

Beyond the price play in the 7-3/4s is underlying value in the new 10s themselves. As senior debt of a restructured entity they might sell above par, in time.

As realistic convertibles, they could benefit from the boost to TSI book value.

Those two reasons give the 10s some intrinsic attraction in their own right. Of course nothing happens if the offer fails.

So we'd suggest exchanging enough bonds to make the offer succeed.

CHASE MANHATTAN BOND MATURITY NEARS AMID NERVOUS TRADING

Chase Manhattan Mtg. & Realty Trust must come up with \$36.7 million by May 1 to repay its 7-7/8% senior notes coming due that day.

The NYSE listed bonds have been unusually active and volatile for a maturing debt issue, falling 15/16 one day last week to 97-1/16. They recovered to 97½.

Does that mean that bond traders fear the trust won't pay off?

We doubt it. Trust spokesmen have said consistently for weeks now that they don't have the cash right now -- but that enough deals are in the works that they can see their way clear to meet to meet the deadline.

A real estate deal is never done until it's signed. But we doubt that there's any more chance that Chase Bank will let its namesake miss a maturity than that Washington will let New York City go bankrupt.

Thus we think the debt will be repaid -- if not on May 1, certainly within a brief grace period.

That makes two other Chase debt issues very attractive for bond investors.

We noted March 10 that some savvy Wall Street investors were picking up the 11-5/8% convertibles, listed PSE. Since then they've moved up a bit to 100¼ to yield just below the coupon rate.

Incidentally, we said they were marginable "to 70%." This is true only if you previously held a straight bond and exchanged it for the 11-5/8s last year.

Otherwise the bond is marginable only to 50%, same as other convertibles.

We'd expect this bond to move up a bit more if and when the senior bonds are paid, perhaps even high enough to get yield down to 10% or so.

And the \$2.25/sh. conversion price isn't too far away either.

Another possibility is the 7½s of 1983, trading at 71 on the NYSE.

They're straight bonds marginable to 70% and yielding about 11% income.

Since they're the next bond maturing after the 7-7/8s, a May 1 repayment would improve their prospects. So much so that they could move up 10 points or so and remain attractive.

The real risk in these remaining issues is that the trust won't pay interest.

CMR stripped out nearly all earning assets to pay down bank debt. About 94% of remaining assets aren't earning income. And Chase Trust agreed to pay banks 6% on remaining debt of about \$150 million.

More assets likely will go to meet the May 1 maturity.

All this means that Chase Trust bonds and shares are highly speculative. But if and when the May 1 maturity is met, CMR will have bought enough time to "do something."

To us that means that a merger or acquisition has to come into focus somewhere to provide earnings to take advantage of the trust's large loss carryforwards.

That makes the shares much less attractive than the bonds. And since it's normally not a good idea to buy convertibles unless the stock is also attractive, that gives a slight edge to the 7½s.

NORTHWESTERN MUTUAL LIFE MORTGAGE & REALTY INVESTORS (11--NYSE-NML) FY Mar 31

Real estate investments: Holdings drifted to \$235 million in Feb. 1978 after peaking at \$260 million in Dec. 1975. Long-term loans are still the portfolio's heart, 60%, with 17% short-term loans, 12% deliberately acquired property and 11% foreclosed. Standard income properties are stressed with the big categories: 25% shopping centers, 24% office buildings, 11% apartments, 10% industrial, 10% land. Long-term mortgages declined \$5 million from their \$147 million peak. No new long-term loans are sought with only \$3 million left to be funded. Most were made at the trust's start, when long-term orientation was popular among the prime insurance trusts. Carrying a 9% contract rate, a more meaningful return with today's higher money costs rests on contingent interest features which added 0.08% in fiscal 1977, more in fiscal 1978 and could be a growing kicker. Short-term loans, 62% below their \$100 million peak nearly four years ago, are being cautiously built-up. There are now nearly \$65 million in short-term commitments, most approved since mid-1977. The construction loans now being taken on are highly selective. They are only on properties, no land is being considered. All have floating rates and takeout loans from the parent adviser. These new loans should be funded at greater amounts than repayments. Taking the March quarter's experience, \$10-20 million could be added to short-term loans over the year meaning a total portfolio of around \$250 million in early 1979. The trust's new loans are generally at 3% over prime compared to 2-2½% over prime which the banks get.

Problem assets have been reduced only modestly to date and little changed as a percentage. Non-earning assets were 10% on Dec. 31 and low-earning 7%. Non-earning mortgage loans are down to \$8.5 million, \$2.5 million on apartments in Amherst, Mass. was successfully restructured with this now viable project accruing at 5%. The main problem loan is \$7.1 million on La Placido shopping center in Tucson, Ariz. Occupancy remains 49% with this still a tough, long-term workout requiring an improved market. At break-even, potential loss is reserved. The remaining loans are \$1.4 million in Cleveland land in foreclosure. This is expected to be sold in 1978 at minimal loss.

Foreclosed properties include about \$12 million nonearning and \$13.5 million low-earning. The non-earning category includes \$5.8 million in 220 residential acres in N. Lauderdale, Fla. They are still fighting zoning but only the county is now required and the end of the process is near. Working with a developer, something should shape up by fall, 1978. There is still \$3.9 million in lots and golf course in Greensboro, N.C. While a few hundred thousand dollars more of lots will be sold this year, ultimate resolution will take much time. Potential loss is reserved. The remaining \$2.3 million is in four land parcels in Memphis, Austin and Tequesta (Fla.). Some should be sold this year. Low-earning foreclosures are down with the Atlanta warehouses 100% occupied and transferred to the equity sector. There is \$7.2 million in the Grand Oceanside Terrace hotel/apartment in Ft. Lauderdale, Fla. Started as a 136 unit condominium, it was renovated to operate as an income property which enables profitability but below market rate. It is hoped that market conditions will permit straight rental as apartments and ultimately condominium conversion. This may require at least two years. There is \$4.2 million in the Olive Square office building in Glendale, Ariz. At 72% occupancy the past six months, further increase is expected shortly. It will then be close to providing adequate return and is being actively marketed, hopefully at a gain. There are two small Ohio office buildings carried at \$2.2 million. One is 90% leased and will be sold, probably at small loss. The other is 42% leased and disposition undecided.

Loss reserve: The trust had \$3.4 million in its loss reserve on March 31. During the quarter, \$60,000 was taken in loss provision to replace what was written off from unprofitable dispositions. While only 1½% of holdings compared to the 13% industry average, it should be remembered most of the portfolio is long term without problems and the short-term problems are well defined and relatively modest. Reserve therefore

looks adequate.

Financing: Total debt of \$144 million was 1.6 times equity, a conservative ratio. Short-term borrowings were \$55 million and \$10 million is borrowed under variable rates at $1\frac{1}{4}\%$ over prime. This means \$65 million of debt floats with market rates while only \$23 million of short-term loans so float. Thus the trust has about \$42 million interest rate sensitive. A higher prime rate can not be fully offset and a 1% increase in the prime rate reduces earnings at an 8.4¢/share annual rate. To accommodate increasing short-term fundings, short-term borrowings of commercial paper or private notes will be used.

Management & REIT status: The trust is sponsored by Northwestern Mutual Life Insurance Co., one of the largest life companies. The adviser participates substantially in many of the trust's investments, having invested about \$100 million along with the trust. The trust has qualified as a REIT since founding.

Recent results & outlook: In the Dec. quarter, 22¢/share was reported. This was operationally improved from the two previous quarters. The trust has been burdened by higher interest rates and foreclosed property expenses. The March quarter saw slightly higher average interest rates but benefitted by the addition of new short-term fundings and slightly decreasing problem assets. Over fiscal 1979, the positive spread from new loans and diminution of problem assets should become meaningful. Failure of reported earnings to break out of the under 25¢/share range the past few years has been somewhat disappointing but 1979 may be the year of light. The 25¢ dividend should be maintained although not fully covered by reported earnings. The trust is considering several foreclosure sales which would incur substantial losses thereby reducing taxable earnings. It hopes to maintain the dividend by using the 32¢ capital gain just taken to boost the June 1978 quarter. The "2" ranked shares are purchasable for high current yield and partial recovery to nearly \$19 book value which looks increasingly solid. (BS)

EQUITABLE LIFE MORTGAGE AND REALTY INVESTORS (22½--NYSE-EQ) FY Oct. 31

Real estate investments: Holdings slipped 7% in the quarter ended Jan. 1978 to \$381 million. Through fiscal 1977, however, the portfolio held to around \$400 million, the trust's stated goal. By category, the portfolio was 58% short-term loans, 33% long-term loans, 4% deliberately acquired property and 5% foreclosed property. Always significant in short-term construction lending, this category has become even more important to EQ, the only REIT active in national construction lending the past few years. With long-term mortgages permitted to run down since 1973, the ratio to short-term mortgages has been virtually reversed from the 60%-36% in favor of long term four years ago. All told, the portfolio is close to its \$409 million peak reached in Oct. 1977, a rare position among trusts other than pure equity.

Holdings are well dispersed over 37 states and Puerto Rico befitting an active national lender. The biggest positions are 10% in Pennsylvania, 8% each Georgia and Virginia, 6% each Maryland, Oklahoma and Texas, and 5% each in Florida and N. Y. The biggest commitment blocks are slated for Hawaii, Kentucky and Texas. Property mix is broad too. In Oct. 1977 the main types were 29% shopping centers, 18% land, 17% hotels/motels, 13% office buildings, 8% apartments and 7% industrial. The main change in emphasis during fiscal 1977 was the hotel category which nearly doubled from 9%. This will continue with hotels representing 35% of unfunded commitments.

The problem category of non-earning loans and foreclosures has held at a sticky 8-10% of investments for two years. Problems have lasted longer than expected but this is true for most of the industry. The latest tally was \$38.5 million, 10.1% of investments on Jan. 31, 1978. This was down \$1.9 million in the quarter but up \$4 million

over the year. The problem category is about equally divided between loans and foreclosures. Most of the loans are being worked out with the borrower with one exception where owner of a \$2.9 million shopping center filed bankruptcy. Some restorations to earning were made, apartments in Columbia, S.C. and the office in Southfield, Mich. Progress is being made with most of the foreclosed properties. The \$4.4 million Philadelphia warehouse is 25% leased. Active buyer interest is reported for a small Charlotte, N.C. office. Disposition has been slow but should begin to pick up. A sizeable fraction could be moved out in 1978, particularly a portion of condos and developed lots. Unfortunately, nearly half the bad loans and foreclosures are in land, some of it raw.

The heart of portfolio strategy is short-term lending because the trust has access to the cheapest short-term borrowing, commercial paper and master notes. Funding some of the \$299 million commitments allow returning the portfolio to \$400 million this quarter.

Loss reserve: There is \$2.1 million reserved for losses, 0.6% of investments.

Financing: Total debt of \$245 million is 1.8 times equity, conservative. Short-term borrowings comprise 91% of debt. Thus 59% of funds float. Management & REIT status: Equitable Life Assurance Society, third largest life insurance company. Sponsor has long established real estate network with field staff of nearly 450. Qualified since founding.

Recent result & outlook: Earnings in the Jan. quarter remained 48¢/share, but down from the 59-60¢ in earlier fiscal 1977. The dividend was just cut to 50¢ from 55¢. Since only 39% of the portfolio floats vs. 59% of funds, the imbalance is vulnerable to recent higher interest rates which cut the short-term portfolio spread to 1.87% in the Jan. quarter from 2.02% in Oct. The April quarter should be little changed as interest rates averaged only .2% more than Jan. The "3" ranked shares may be held for income with little change until problems are reduced or interest rates reverse. (BS)

B.F. SAUL REIT (6-3/4-NYSE--BFS) FY Sept. 30

Real estate investments: It's fish-or-cut-bait time for this giant property and mortgage combination trust. The trust has insisted in paying full interest on about \$125 million bank debt while it tried to restore earning power to nearly 60 properties it had foreclosed.

Now those and voluntarily acquired properties, with \$225 million total gross investment, are earning nearly 8% free-and-clear income before debt service, and the trust is approaching breakeven cash flow before noncash depreciation charges. So the trust is talking with banks and mortgage lenders about mortgaging these properties for about \$60 million, atop \$64 million current mortgage debt, with proceeds going to repay over half the \$112 million bank debt remaining. Properties that can't measure up to support mortgage debt likely will be offered for sale. It's indicated BFS may lighten up on apartments in any event because of the shorter depreciable life, intensive management, potential for new competition, and threat of rent controls in some areas.

Saul's gross property holdings before depreciation were \$255.8 million at Dec. 1977, divided 88% operating properties, 2% earning leasebacks, and 10% idle land and condominiums. The 88% in operating properties earned 7.9% operating income on average gross investment in the Dec. 1977 quarter. They are divided into four major property types: 35½% shopping centers, 33% apartments, 10½% motels, and 9% office and industrial.

Shopping centers are the best performers, returning 8.3% on gross investment in the Sept. 1977 fiscal year and a seasonally high 9.8% in the Dec. 1977 quarter. BFS owns 25 shopping centers with 3.9 million square feet of rentable space; most centers were acquired in exchange for shares with Giant Food Properties, Inc. in 1972 and consist mainly of smaller strip centers, generally below 100,000 sf, with a grocery chain

anchor. It has acquired several large, mall-type centers via foreclosure and reports most are either fully leased or nearing full occupancy. Some concessions were made on some centers to attract new tenants, however, limiting some returns over the near term.

Apartments are the other major category and they earned only 5.3% in FY 1977. The Dec. 1977 quarter return jumped to 7.4%, still not enough to support 9½% mortgages. Saul owns 31 projects with 6,523 dwelling units but recently sold or is selling three Texas projects with 409 units and \$5.2 million gross cost. Additional sales are likely.

Six motels contain 1,215 rooms and earned 9.4% during 1977, in line with generally higher motel returns. Return dropped to 7.9% in the seasonally weaker Dec. 1977 quarter. Office and industrial properties are weakest performers, returning 2.4% in 1977 and 2.1% in the Dec. 1977 quarter. One industrial property is vacant.

Saul also has \$22 million invested in land, not currently productive. Several major parcels are rated as prizes for future development, however, including \$980,000 in the 43-acre Avenel tract on I-270 in Gaithersburg, Md.; and \$5.9 million on 160 acres at I-75 and the Perimeter Hwy. in northwest Atlanta. Total mortgage loans have now fallen to about \$33 million and while most remaining loans are classed as long-term, further liquidation and payoff is expected.

Nonearning investments including the idle land total 13.3% of investments, well down from peaks. Another 8.4% of assets are classed as low-earning.

Depreciation & loss reserve: BFS has accumulated depreciation of \$16.8 million or \$2.87/sh. based on historical property costs. It has set aside \$3.5 million as reserve for possible future investment losses, equal to 1.3% of investments.

Recent results & outlook: BFS shares advanced to a new recovery high of 7 last week on heavy volume. It's clear that BFS losses are narrowing and the operating loss before depreciation narrowed to 8¢/sh. in the Dec. 1977 quarter. Depreciation of 21¢/sh. brought the reported loss to 29¢/sh. But operating losses have brought Saul's net book value down to \$5.44/sh. and this plus \$2.87/sh. depreciation has to be considered as Saul's earning base, in effect setting \$8.31/sh. as Saul's earning base. Some Wall Streeters have been buying on the basis that book value is understated because most property was acquired at distress prices via foreclosure. They point to Saul's bricks-and-mortar replacement cost, computed under S.E.C. rules, of about \$16.54/sh. more than historic cost book value. We believe real estate is worth what it earns and thus would be cautious about new purchases at much above current prices. Dividend resumption is possible in 1979, however, meaning you can wait longer.

RELATIVE APPEAL RANKINGS: SUMMIT PROPERTIES ASSET SALE SCRUBBED, RANKING REDUCED

Summit Properties has called off sale of about half its properties to Los Angeles investor Charles Z. Wick (RTR, Dec. 22, 1977). Parties couldn't agree upon some proposed modifications to the initial sale agreement.

But Summit still expects to be profitable in its March 31, 1978 taxable year (which differs from its Oct. 31 fiscal year).

It has leased about 80% of space vacated when W.T. Grant Co. went bankrupt and vacated four stores. Leases for other space are in the hands of lawyers.

Dividend resumption may be another year off but is now a distinct possibility.

All this is upbeat and the shares haven't fallen back much on news of the Wick termination. But at 4½ (OTC) they are slightly less attractive and so we're changing our RELATIVE APPEAL RANKING from No. 1N (highest appeal but no dividend) to No. 2N (above average).